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General Business Conditions

THE improvement in demand which many industries experienced in July has carried through August in a very satisfactory manner. It is now plain that by early Summer many manufacturers had cut their stocks and commitments for materials as low as they could go, in relation to sales, and that the way was cleared for a pickup in buying. Once started, improvement spreads naturally. Markets strengthen and, for the time being at least, people expect firm or higher prices. Buying goes around the circle. In steel, and perhaps in related lines, possibility of a strike was an additional stimulus to covering.

Distributors also in many cases had let stocks and commitments run down. They had lived off inventories as long as they could, and had to come back into the markets to supply their trade. Examples are refrigerators and batteries. In both, months of slow buying and production curtailment finally cleared up excess field stocks, new orders came in to manufacturers, and workers have been recalled and production stepped up.

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Sales of lead and copper have continued large and prices of both have advanced further. Textile business has been active, particularly in cotton and rayon goods, prices have rallied from the Spring lows and in some cases spot deliveries command premiums. New orders for paperboard, a commodity of widespread use, have been the largest since last Fall. Prices of some chemicals, lumber and petroleum products have firmed. The pickup has not reached the heavy machinery and equipment industries generally, but otherwise exceptions are few. Finally, the stock market has been buoyant, which both reflects and creates better sentiment.

Causes of Improvement

Whether or not the current improvement goes far or lasts long, it demonstrates the recuperative powers that rest in business itself. During the Spring, and into July, the Federal Reserve Board's index of industrial production dropped at the rate of five points a month. Many industrial workers suffered layoffs or short time, and sentiment was disturbed by fear that a spiral of declining consumption and employment would start. The other side of the speedy decline, however, was the speedy adjustment of inventories and commitments, and also, in important instances, speedy reduction of prices. Consumption was sustained at relatively higher levels than output. Pipelines that were full or overflowing began to empty. From these adjustments the increase in new orders followed, and the refilling of order books, leading to expanded output in textiles and other lines, is checking the decline in industrial production.

The supporting influences have been, first, the cautious policies followed by business men during the past two years, which help to limit the extent of the necessary correction, to minimize its losses, and to speed it along; and, second, the factors sustaining consumption. Buying power has held at high levels. Latest figures on total personal incomes, compiled by the Department

of Commerce, show an annual rate of $213.5 billions for June, only 2 per cent below the all-time peak of last December. Total retail expenditures in July were only 4 per cent below December, after adjustment for seasonal differences. These figures are in dollars. Allowing for lower prices, for food and apparel particularly, it is clear that final consumption of goods and services has held up much better than the pessimists expected. This is the base upon which the improvement has developed.

Automobiles, construction and many of the heavy machinery and equipment industries have given strong support to employment and purchasing power. During the past few months automobile factories have reached new peaks in sales and output. The dollar volume of construction put in place in the first seven months of this year, according to Department of Commerce estimates, was 3 per cent higher than a year ago. New orders for machinery and equipment have dropped in many lines, for example, railway cars and more recently in machine tools; but total capital expenditures so far this year have equalled the most optimistic hopes.

It is also clear that the emphasis given in earlier discussions of the outlook to the financial strength and liquidity of both corporations and people was not misplaced. The price decline during the Spring in some areas was violent and inventory markdowns were large. They have left their impress on corporation earnings. But in many cases reserves previously accumulated have absorbed losses, and companies going into the red have been mostly of the weak or marginal kind. Personal spending has declined for things no longer so urgently wanted, or where prices or quality were considered out of line, but people have been able to buy all the automobiles that could be turned out. They have had reserves of savings to fall back on, and in the aggregate have continued to add to their liquid savings, although at a slower rate. People out of work have drawn on the unemployment insurance funds, and farmers have had access to government support programs. Foreign grants and aids have kept exports going. As many expected, this combination of financial strength and income supports has cushioned the decline.

The Longer Outlook

The important question now is what the Summer pickup signifies in the longer outlook. Where it leads to increased production, as in textiles for example, it adds to purchasing power by reason of added employment and greater demand for materials and supplies. On the other hand, it would be imprudent to count too certainly on a general industrial expansion. The improvement has come before some of the most important industries have had any significant decline. It must be supposed that in due course the automobile manufacturers will catch up with their market, just as the refrigerator and battery manufacturers did, and that construction will show some drop. The capital goods outlook is uncertain. Producers are working on backlogs and are steadily paring them down. Many corporations are completing their immediate postwar expansion programs this year and will spend less on plant and equipment in 1950.

If the catching up which hit lighter industries earlier also has to come in automobiles, construction and other capital goods, one of the strong supports of employment and buying power will be weakened. Farm income and farm purchases are expected by many to decline, in consequence of lower prices for feed grains and livestock and lower production next year, possibly through acreage restrictions, of some of the crops which are supported. The current surplus of exports, which is dependent on foreign grants and aids, must decline if the scheduled reductions in these aids take place.

Price expectations this Fall are unlikely to be bullish enough to stimulate a strong inventory buying movement, for supply and demand prospects in the main do not support such expectations. Business men, particularly those concerned with imported commodities, are apprehensive lest currency devaluations exert deflationary influences. While business buying has had to recover to levels more in line with ultimate consumption, current opinion suggests that it will not become reckless, and that the caution which has proved its worth will not be thoughtlessly abandoned. The position will be stronger and the outlook brighter if conservatism continues to rule now.

The Steel Wage Case

During August the board appointed by President Truman to examine the wage and other demands made by the steel workers union has been holding hearings. Strikes pending in other industries are in abeyance until after this board reports, and the outcome of the steel case doubtless will be a principal influence in the outcome of many others. The tendency of so-called "fact-finding" in wage cases is to concentrate on determining "ability to pay," and the very danger that the findings of the Presidential board in the steel case may set a pattern for other industries demonstrates the weakness of the ability-to-pay

approach. For ability-to-pay varies from industry to industry and from company to company. If it were rigidly followed there could be no such thing as a "pattern". Yet experience indicates that in circumstances like the present, if a wage increase is granted in the key case, a pattern develops. For unions demand equal pay for equal work and competition assures that increases in one plant must be met by increases in competing areas and occupations. The burden falls heavily on the smaller and weaker companies.

Few think that a fourth round of wage increases could be passed along in prices under the changed business conditions, and the unions of course insist that they should not be passed along, but should come out of profits. Mr. Murray of the C.I.O. stated the case at the opening of the steel hearings by saying that "the steel companies have continued to enjoy and are still enjoying colossal profits . . . If their business were in a depressed state and they were operating at only a moderate profit level or at a loss . . . they would of course have access to the enormous reserves which they have accumulated over many profitable years."

Of course the "reserves" which Mr. Murray says "result from the paying out to the stockholders only a small proportion of each year's net earnings" are not in a form available for distribution as wages or anything else. They are reflected on the balance sheets in an increase of surplus accounts, plus contingency or general reserves in some cases; but the cash has long since been invested in plant and equipment or other working assets, for the purpose of expanding and modernizing the industry and financing the growth of its business.

Wage Demands and Capital Expenditures

The basic question involved in proposals to take another slice out of corporate earnings for fourth round wage benefits is what, if granted, their effect would be on employment, the general economic situation, and the public welfare. In view of the indications that expenditures for plant and equipment, and therefore employment and payrolls in the capital goods industries, are in a declining trend, it would appear that the effects upon these expenditures should receive first attention. Earnings in the steel industry, as in business generally, increased sharply after the war to an alltime peak in 1948. To be sure, as computed under customary accounting procedures they are overstated by the effects of price increases upon inventories and by the inadequacy of depreciation charges based upon original costs to cover the present-day replacement costs of plant and equipment. Passing over this, however, the pertinent question is what happened to earnings. Did they go to swell the income of shareholders and enhance the market value of their investments? If not, who benefited?

The answer in the case of the steel industry is to be found in the following table:

Changes During and Since the War in Wages and Salaries, Taxes, Net Income, Dividends, and Capital Expenditures of Leading Steel Companies

(In Millions of Dollars)

Year	Wages & Salaries	Total Taxes	Net Income	Dividends Paid	Reinvested Income	Capital Expend.
1940	$1,180	$225	$281	$138	$143	$171
1941	1,679	591	327	167	160	295
1942	2,176	776	221	153	68	265
1943	2,654	617	201	149	52	289
1944	2,647	448	180	139	41	136
1945	2,337	245	184	140	44	148
1946	1,952	245	265	147	118	291
1947	2,429	374	412	184	228	496
1948	2,759	494	542	205	337	583
% Change 1940-48	+134	+120	+93	+49	+136	+241

Source: Tabulations by American Iron & Steel Institute of reports of companies representing about 90% of the entire industry.

This table shows that although between 1940 and 1948 wages and salaries increased by 134 per cent and taxes by 120 per cent, net income increased by 93 per cent and dividends paid by 49 per cent. Retained earnings increased by 136 per cent, and all were reinvested in the industry.

At the close of the war the steel industry faced an unprecedented and insatiable demand for its products from both domestic and foreign buyers. To catch up with this demand, the industry spent in 1946, 1947 and 1948 a total of $1,370 million for plant expansion and modernization. Despite retirements of obsolete and uneconomic equipment, it raised its ingot production capacity to a new peak of more than 96 million tons, which compares with 82 million in 1939 and 71 million in 1929. During 1949 it is estimated that an additional $627 million will be spent. This aggressive and costly program has given the country what it wanted — a great increase in the supply of steel. The shortages have been overcome, black markets have been eliminated and the keenly competitive conditions traditional in the industry are fast returning.

This tells where the earnings went and who was benefited. To meet the capital expenditures of $1,370 million in the three years, retained earnings supplied $683 million, or one-half. The remainder was financed out of cash representing depreciation charges or obtained from increases in short and long term debt. While working capital has increased as compared with prewar, the proportion of cash to current assets and liabilities is smaller.

Outlook for Profits

The unions will doubtless say that conditions have changed and that amounts needed for capital expenditure hereafter will diminish. The other side of this statement is that if conditions have changed profits also will diminish, and the drop is already showing. Mr. Murray stated to the board that "if the steel companies were operating under June 1949 price and cost conditions, and at the same rate of production as in the first quarter of that year, their profits would run more than half again above the profit rate which actually prevailed in the first quarter of 1949." The unreality of the assumptions and the arithmetic involved in this statement is shown by the actual reports of the ten largest steel companies, all published within less than a week after Mr. Murray's prediction, which showed from the first to the second quarters of this year declines in net income in every case, ranging from 8 to 82 per cent.

Mr. Murray further stated that the industry operating at only 70 per cent of capacity would earn nearly 10 per cent on its investment. But the record since 1925 shows only four years in which this return was realized, and in those years operations ranged from 88.5 to 97.3 per cent. He also asserted that "at June 1949 prices, wages, and material costs, the break-even point of the industry would be at 32 per cent of capacity." Again, the record shows that during the years 1931, 1933, 1934, and 1938, when operations were above that rate and before the great rise occurred in wages, taxes and other costs, the industry operated in the red.

In twenty-four years ending with 1948 the earnings of steel companies on net assets averaged 5.2 per cent and ranged from 14 per cent in 1948 to minus 4 per cent in 1932. The profit margin on sales from 1933 through 1948 (earlier figures not available) averaged 3.5 per cent and in 1948 was 6.7 per cent; it ranged from 8.1 per cent in 1940 to minus 6.7 per cent in 1933. It is plain from this record that earnings in 1948 and the first quarter of 1949 can hardly be relied upon as an indication of earnings in the years ahead, or as a basis for a permanent increase in operating costs. If in these circumstances the increase in costs comes into effect, steel in some degree will be priced out of the markets, the incentive to make capital investments will be diminished, and the ability to pay for them will be reduced, — this at a time when the Government is making every effort to demonstrate that the country requires still greater steel-making capacity. The same considerations apply broadly to other industries.

The argument that a business slump will occur unless the slice of business income taken by labor is increased by higher wages and other benefits falls afoul of the facts. It implies that the earnings retained by business are not spent or distributed, — at least not in ways that promote the general welfare. But the steel figures prove the contrary. The unions demand a larger percentage share of business income. If business declines they will receive a larger share, because wage payments are relatively inflexible as compared with profits, which are the residual item. But such wage gains are illusory. Their cost is unemployment.

New Credit Moves

Following up the new open market policy announcement of June 28, the lapse of the "supplemental" reserve requirements and consumer credit regulations on June 30, and the reductions in reserve and stock margin requirements during the Spring, the Federal Reserve Board on August 5 ordered further reductions in reserve requirement percentages for the member banks of two points on demand deposits and one point on time deposits. The order had the effect of freeing approximately $1.8 billion bank funds for lending or investing. To spread out the impacts on the markets, the reductions were made effective in half point or one point steps. The new schedule, which came fully into force September 1, sets requirements against demand deposits at 22 per cent for New York and Chicago banks, 18 per cent for reserve city banks, and 12 per cent for nonreserve city or "country" banks. The new requirement against time deposits is 5 per cent for all classes of member banks.

In a brief public statement commenting upon the action, Mr. McCabe, Chairman of the Board of Governors of the Federal Reserve System, stated that it was taken "with primary regard to the general credit and business situation and the maintenance of orderly conditions in the government security market."

Inasmuch as there was no problem of disorderly conditions in the government security market which a reduction in reserve requirements could help to correct, it was generally assumed that the Board's move was primarily dictated by its appraisal of the credit and business situation. Indeed, the action required selling of government securities by the Federal Open Market Committee to ease the impact on the market. In the three weeks ended August 24 the Federal Reserve Banks sold, or permitted to run off at final maturity, $890 million of short-term government securities. Excess reserves rose from an

average level of $900 or $950 million in the latter part of July to an average above $1 billion in August.

Short-term money rates held fairly even during August, despite the reduction in reserve requirements. This was explained by simultaneously increased supplies of short-term Treasury paper on the market, coming not only from the Federal Reserve but also from the Treasury and from corporations switching funds out of marketable governments into Savings notes. The new weekly issues of Treasury bills during the month were sold at average rates of between 1.01 and 1.05 per cent, and longer-dated certificates were traded on yield bases running from 1.04 to 1.07 per cent.

The Federal Reserve authorities, as in July, refrained from operations in the market for long-term government bonds and allowed their action to register its full effect upon the bond market. Prices of long governments were immediately marked up a quarter of a point or better on top of previous gains. Corporate and municipal bonds rose sympathetically and new issues in both classes found a ready demand. A $100 million issue of 2¾ per cent 25-year Canadian Government bonds, priced at 100¼, was a quick sell-out.

Treasury Financing

The U. S. Treasury took advantage of the lower structure of rates in the market to announce, August 22, that its $1.3 billion 2 per cent bonds called for payment September 15 would be refunded into one-year certificates of indebtedness carrying a rate of 1⅛ per cent. Since last Fall the rate offered on one-year certificates has been 1¼ per cent. The October 1 maturity of $6.5 billion certificates is also to be rolled over into new certificates, the rate and term of which were not revealed. The Treasury announcement stated that Treasury notes — obligations of more than one year's term but not more than five — would be offered in connection with the refunding of $4.4 billion Treasury bonds called for redemption on December 15.

The Treasury also took action during August to fortify its cash position against the prospective deficit for the current fiscal year. Treasury bill offerings were stepped up to $1 billion a week, which brought in $600 million additional cash during August. More money came in from a somewhat unexpected source, sales of Series D Savings notes which offer nonbank investors a return of 1.40 per cent as a three-year investment and rates graduated up to that rate for holding over shorter periods. With the decline in available yields on marketable Treasury paper since June, Savings notes became a more attractive media for short-term investment, and a great deal of switching developed during July and August from short-term governments into the Savings notes. Sales of the latter brought in to the Treasury, over and above redemptions, $1.5 billion during the first seven weeks of the new fiscal year.

Myth of "Credit Stringency"

The publicity given to the reserve requirement changes may have led some people to infer that a period of general credit stringency existed or was threatened. This is not true. The broad fact is that the country has had "easy money" policies — transcending anything in previous experience — for at least fifteen years. There have been gradations in the "easiness" of "easy money", but no policy has been undertaken which would put creditworthy borrowers under strain or cause them difficulty in raising funds to carry on. While there are always marginal or submarginal applications for loans, which banks decline, the idea that we have been suffering general credit stringency is a complete myth.

Notwithstanding, bills have been introduced in Congress to raise the lending authority of the Reconstruction Finance Corporation by $2½ billion more, and to remove restrictions on its loan maturities. The present maturity restrictions, enacted into law only as recently as May 1948, are ten years for business loans and forty years for public works loans.

These proposals are not only superfluous, in view of existing easy money, but they are objectionable by reason of their long-term implications. The objections were elaborated by Earl R. Muir, president of the Louisville Trust Company, on behalf of the American Bankers Association, in testimony before the Senate Banking and Currency Committee. Removal of statutory limitations on RFC loan maturities, he pointed out, could lead to permanent equity investments by the government in private enterprise. If the Congress wants to aid small business meet its capital requirements, Mr. Muir stated, "the best form of aid it can provide is tax relief which will enable small business to accumulate and attract the capital it needs as the business grows." In its present financial plight, Mr. Muir questioned the wisdom of the use by the Federal Government of its credit to raise money for the RFC to lend. "Adequate working capital," he said, "is presently available from the banks and other private credit sources."

Discussing the decline in bank loans since last December, Mr. Muir stated that the cause has

not been "any reversal of bank lending policies" but a combination of lower commodity prices, restricted inventory policies on the part of business, lower industrial production, and the refunding of bank loans into new issues of industrial securities under present favorable market conditions. "Banking has responded to the legitimate credit needs of business, notwithstanding many uncertainties regarding monetary policies, and many disturbing legislative proposals affecting bank reserves which have been submitted to the Congress in recent years." Mr. Muir quoted from the mid-year report of the President's Council of Economic Advisers to support his assertion that the business adjustment of the past several months has not developed into a period of "credit stringency".

In this general connection it is worthy of note that the $22.9 billion aggregate of loans on the books of the reporting banks as of July 13 – the low point so far this year – is almost precisely the loan level that prevailed in November 1947, when the President called Congress into a special session to deal, in part, with inflation and proposals for placing some restraint on bank credit.

Influence on Bank Loans

When banks are already well supplied with funds ready to be lent at low rates, reserve requirement decreases can hardly make banks very much more receptive to loan applications from creditworthy borrowers. They can and do affect the price levels and tone of the investment market and have played a definite part in encouraging the absorption of new bond offerings, through security underwriting and dealer channels, at high prices and low yields.

One of the things that the authorities – and the banks – have always to consider is that policies of easing the credit supply will sometime have to be turned around. When loan rates are already about as low as they have been in history, there is dubious wisdom in pushing for even lower rates, which may add perhaps very little to the amount of credit called into use, but can encourage underestimation of risk factors in credit operations, set the bond market up on stilts, and add immensely to the difficulties of reversing course. If an economy languishes despite cheap money, the time is due, if not overdue, for giving attention to other factors.

The Sterling-Dollar Problem

During the present month Britain's Chancellor of the Exchequer and her Foreign Minister will meet in Washington with the corresponding high officials of the United States and Canada to continue discussions regarding what on this side of the Atlantic is usually referred to as the "sterling crisis" and on the other side as the "dollar shortage crisis". This meeting will be the second round of talks between Sir Stafford Cripps and Messrs. Snyder and Abbott, and their staffs. The first, largely exploratory, took place in London last July. The tripartite talks will be followed by the annual meetings of the governors of the International Monetary Fund and of the International Bank.

The balancing of payments between the United States and Great Britain has been one of the most intractable postwar problems, and it is highly questionable that this month's discussions will provide a quick and easy answer. The problem involves achieving equilibrium between the whole of the "dollar area" and the whole of the "sterling area",* of which Great Britain is the central banker. It includes adjustment of a complicated industrial economy like Britain's to changing world markets in the face of social and political pressures at home. Involved also is the problem of the restoration of international currency convertibility; for as long as the British are unable to use their earnings derived from trade with "soft currency" areas to settle their deficit with the dollar area countries, the "dollar shortage" is likely to persist.

It was "agreed" at the three-power talks in London last July, according to the official communique, to explore remedies "other than financial assistance such as that provided by the United States and Canada." Just what this means was not elaborated upon beyond the statement that "no suggestion was made that sterling be devalued." To Americans this would seem to imply recognition by the British of the need for becoming adjusted to a more competitive world, with greater stress upon measures and policies calculated to increase efficiency, cut costs, and reduce dependence upon foreign aid.

**The sterling area* is an association of countries within which, generally speaking, the pound sterling arising from current trade and service transactions is freely convertible. At the present time the sterling area consists of the British Commonwealth countries, Canada excepted, together with Eire, Iraq, Iceland, and Burma. With the exception of South Africa, which is responsible for its own gold and dollar expenditure, these countries are also members of the London gold and dollar pool.

The British regard as *the dollar area* the "dollar account" countries with which they have to settle in dollars: the United States, Cuba, Mexico, Colombia, Ecuador, Bolivia, Venezuela, the Caribbean and Central American Republics, and the Philippines. Canada, while technically not a "dollar account" country, is usually considered as in the dollar area.

By contrast, British thinking tends to view the crisis more as a "dollar shortage" than a sterling problem, and appears to be veering towards such proposals as American support of prices of British area primary commodities through stockpiling purchases or participation in international "stabilization" agreements, implementation of the President's "Point 4" program of expanding American investments in undeveloped areas abroad, simplification and reduction of American tariffs, and even from some quarters the suggestion of an all-round increase in the price of gold in order to add to the dollar earnings of gold-producing countries, primarily South Africa.

Extent of British Recovery

In any analysis of the British problem it is important to recognize the very substantial recovery which Britain achieved during 1948. Table 1, based on the British Government's Economic Survey for 1949, issued last March, indicates that in 1948 she reduced her overall current account deficit (trade, shipping, tourist, and interest, as distinct from capital movements) by about £500 million compared with 1947. There was a small surplus of £30 million during the second half of 1948.

Table 1 — Britain's Balance of Payments (Current Account Only), Deficits and Surpluses, by Areas

(In Millions of £)

	1947 12 mos.	1948 12 mos.	1948 July-Dec.	1949 Jan.-June
Dollar area	—655	—311	—125	—160
Sterling area	+ 55	+225	+160	—
Western Europe	— 25	+ 80	+ 45	—
All other areas	— 5	—114	— 50	—
All countries	—630	—120	+ 30	—

This marked improvement in the overall balance of payments was accomplished by a great expansion of production and exports since the Fall of 1947. As Sir Stafford Cripps stressed in his July 6 speech in the House of Commons, Britain's production is at a record level in the whole of her history. Overall industrial output in the last few months was at least 30 per cent above 1938.

The "Achilles Heel"—The Dollar Deficit

But as shown in the table above, the overall figures on Britain's balance of payments conceal the "Achilles heel" – the continuing deficit with dollar area countries. Nor is this the whole story. For besides responsibilities for her own deficit with the dollar area, Britain had (1) her responsibility for the dollar deficit of the rest of the sterling area, and (2) the obligation to settle in gold or dollars part of her balance of payments deficits with third countries, such as Belgium and Switzerland. Other sterling area countries are running dollar deficits, partly because of their heavy requirements for American capital goods, and partly because the inflationary expansion of their purchasing power has encouraged imports and discouraged exports.

Table 2 shows the net gold and dollar deficit of the entire sterling area, together with figures indicating how it was financed. Through 1948 this deficit was being successfully reduced. By the end of the year it had been brought down to where it was covered by U.S. European Recovery Program grants, plus small drawings on the International Monetary Fund and the sterling area gold and dollar pool.

Table 2 — Origin and Settlement of the Sterling Area's Gold and Dollar Deficit

(In Millions of £)

	1947 12 mos.	1948 12 mos.	1948 July-Dec.	1949 Jan.-June
Origin of the Deficit				
U.K. deficit with dollar area	655	311	125	160
Deficit of rest of sterling area with dollar area	202	26	9	37
Net gold and dollar payments to non-dollar countries	167	86	35	42
Total gold and dollar deficit	1,024	423	169	239
Settlement of the Deficit				
Drawings on:				
U.S. loan	707	74	—	—
Canadian loan	105	13	—	14
South African gold loan	—	80	—	—
Intern'l Monetary Fund	60	32	6	8
E.R.P. grants	—	169	147	166
Decrease in gold and dollar holdings of the sterling area	152	55	16	51
Total settlement of deficit	1,024	423	169	239

Source: British Information Services.

Strengthening of External Capital Position

Still another aspect of the improvement in the British position emerging from the complicated tangle of exchange transactions has been a substantial reduction over the past two years in Britain's huge sterling liabilities incurred during and immediately after the war, and a building up of new external capital assets.

As seen in Table 1, Britain's deficit with the dollar area has been accompanied by the accumulation of important surpluses in other areas. These surpluses, however, consist largely of exports paid for by releases of blocked sterling and exports representing British capital investments overseas, chiefly in Commonwealth countries. Thus in the two years 1947 and 1948, Britain paid off some £350 million of sterling indebtedness, reducing the total to £3,362 million, while at the same time increasing external capital assets by £344 million. This is shown in the table following.

The increase in external capital assets, representing mainly investments in Commonwealth food and raw material production, was described

Table 3 — Changes in Britain's Sterling Liabilities and External Capital Assets
(In Millions of £)

	1947	1948
Changes in sterling liabilities		
In the non-sterling area	+ 3	—246
In the sterling area	—145	+ 35
Net change	—142	—211
Changes in external capital assets		
In the non-sterling area	+ 78	—100
In the sterling area	+179	+192
Net change	+252	+ 92
Net reduction in liabilities plus net increase in external assets	394	303

Based on Economic Survey for 1949.

in the Economic Survey for 1949 as an "indispensable element in the programme for developing new sources of supply upon which our ultimate hope of solving the dollar problem is largely based."

Thus Britain has been paying off debt, adding to overseas investment, and improving her position for the long run. It is only fair to point out, however, that there is another side to the matter. As the Federation of British Industries has indicated, "a large part" of the exports with which Britain balanced her accounts last year was in payment of wartime debts – what the British call "unrequited exports": that is, exports for which no imports were received in return. These releases of blocked sterling are continuing, and are causing some further expressions of misgiving. Of releases recently granted India, The London Economist observed that they were "inspired mainly by a desire to do nothing which might disturb employment in the export industries which supply the Indian market," adding that they "absorb British resources which ought to be employed elsewhere." Also, even the soundest and most desirable new overseas investments will yield their return only in the future.

Acceleration of the Dollar Drain

It was in the midst of this generally improving picture that affairs took the sudden turn for the worse this Spring. As shown by the table below, the sterling area's dollar deficit during the April-June quarter of 1949 almost doubled as compared with the three preceding quarters. By the end of June, Britain's gold and dollar reserves had fallen to £406 million, and were being drawn upon at a rate which, if continued, would exhaust them in about 18 months.

Sterling Area Gold and Dollar Deficits and Reserves
(In Millions of £)

	Overall Deficit	Reserves (end of period)
1947 (full year)	1,024	512
1948		
Jan.-March	147	552
Apr.-June	107	478
July-Sept.	76	437
Oct.-Dec.	93	457
1949		
Jan.-March	82	471
Apr.-June	157	406

Source: British Information Services.

Of the various factors contributing to this drain, the most important has been what Sir Stafford Cripps apparently had in mind when he spoke of the "change in the financial and commercial climate." Falling prices and lessened demand have cut sharply the dollar receipts from various sterling area primary products. Rubber, tin, cocoa, wool and diamonds, which were yielding around $120 million per quarter up to last March, are estimated to have brought in only about half that in the following April-June quarter. At the same time, with the general shift in world markets from sellers' to buyers' advantage, British exporters, in common with business everywhere, are feeling more of the hot breath of competition.

Besides the falling off in sales to the dollar area, the accelerated drain reflected some increase in United Kingdom imports from the United States, and a substantial loss of gold to Belgium and Switzerland. Finally, the situation was aggravated by apprehension of possible sterling devaluation.

It would be a miracle, in view of the widespread uncertainty and the ingenuity of speculators and traders, if there were not some leakage in the admittedly tight exchange controls. For example, Australian wool and Malayan rubber have been purchased by countries outside the sterling area with transferable and other sterling available in those countries, and resold in the dollar area. The effect is that the dollar proceeds of the sales have gone to the intermediaries rather than to the sterling area pool. Controls have been tightened further to minimize these and other leakages.

Interim Measures to Save Dollars

Such was the situation which the Chancellor of the Exchequer disclosed to the House of Commons in July, together with tentative plans for remedial action. As an immediate corrective step the Government ordered its purchasing departments to pare new dollar purchases to the bone.

In addition, Sir Stafford laid before the House a new austerity program calling for a 25 per cent cut in British imports from the dollar area (including Canada). This pruning, which is to affect largely imports of tobacco, cotton, sugar, timber, paper and pulp, machinery, steel, and nonferrous metals, is expected to result in a saving of about $400 million by next July. Subse-

quently, the Finance Ministers of the Commonwealth countries agreed to recommend a similar cut in dollar purchases, to effect a possible further saving of $300 to $400 million annually.

In announcing these measures, Sir Stafford acknowledged that they represented "a purely negative approach to the problem," and offered "no solution of our difficulties." Beyond such stop-gap action, there must be, he said, "longer-term and more fundamental measures."

This brings us to the real heart of the problem. What should be the nature of these "more fundamental measures"?

Views on the Longer-Term Problems

Apparently there are three main schools of thought as to the principles that ought to be followed in restoring British balance of payments equilibrium. One holds that Britain's difficulties are all the fault of America for being so inconsiderate as to have a business slump and stop buying British products. While there is no doubt that a large segment of British opinion is at least tinged with this idea, the theory finds its most extreme expression in such statements as the following from The Tribune, a British weekly reflecting the Labor viewpoint:

> The uncontrolled American economy, with its growing cohorts of unemployed and its falling internal purchasing power, is becoming more and more a threatening menace to our recovery . . .

The left-wing weekly, The New Statesman and Nation, is even more ungenerous:

> The difficulties in which we find ourselves are primarily due to the wilfulness of Congress . . . By seeking to cut allocations for foreign spending and by economizing on the stockpiling of raw material, it is exporting the American slump to Europe and to such producers of raw materials as Australia, Malaya and West Africa.

Since the theory is that the new crisis is the product of capitalistic instability, the argument of this school is that the cure is more socialism.

With this whole thesis The Economist registers an impatient dissent in its issue of July 9:

> There is a tendency among some of the Left-wing partisans to say that it is an unnecessary crisis that need never have happened if it were not for the chronic and incorrigible instability of American capitalism. This is an attempt to establish an excuse. It is a smokescreen of poison gas.
>
> It is not true that the American economy is slumping. The level both of general demand and of economic activity in America is still a long way above any definition of normal that the world has ever before known, and if British socialism cannot adjust itself to as minor a quaver as this, then it is too delicate for the real world. Labour Members of Parliament would do well to remember that their government would have been out of office in collapse and chaos years ago if American capitalism had not been willing to subsidise it.

A second school of thought calls for Britain and the Commonwealth to work out their destiny free from American aid. It would concentrate on developing an expanding sterling trading area, held together by bilateral trade and financial agreements.

But not along this line either does The Economist (July 16) see a promising solution:

> The sterling area, as at present constituted, can provide neither the markets nor the supplies to replace the dollar area. And if the argument is that other countries – indeed, the whole non-dollar, non-Soviet world – are to be attracted into such a system, the answer must be how they are to be attracted if it is not attractive? Who will enter – who will freely step in – a sterling area of which the subscription is the obligation to buy dear British goods instead of cheap goods from other suppliers?

Still a third school of thought holds that within what the Economist calls the "over-planned and over-controlled and over-protected" domestic British economy, a return to competitive conditions is the only effective way of getting costs down and efficiency up, and selling more goods and services overseas.

A "Simple Test" of Sound Policy

The philosophy of this last school might well be epitomized in The Economist's prescription, as follows:

"The simple test of all policy now must be whether or not it serves the purpose of reducing costs of production." (Italics ours.)

In hammering home this point The Economist says (July 9):

> The great defect of the British economy is its very high costs of production. It is not that British productivity is not high, but that the remuneration the British people exact for their production is still higher . . . British costs of production are too high not merely for the dollar market, or for the overseas markets in general, they are too high for the British market itself. To give a simple illustration of this, an attempt has been made to estimate roughly how many weeks the average British wage-earner would have to work for his wages (after tax) to equal the price of five standard British-made objects, before the war and now. These are the results:

	Prewar	Now
Standard council house, weeks....	112	213
Cheapest British car, "	39	55
Cheapest motor-cycle, "	11⅜	17½
Cheapest man's suit, days......	5	7
Average radio set, weeks..........	3⅜	4½

> These figures can be used to show that the standard of living has fallen. But that is merely the inverse way of saying that the real cost of production – the number of week's work necessary to produce something – has risen. This is a real and fundamental ratio. Until it is put right, no amount of juggling with prices and exchange rates will enable the British people to earn as good a living as they did before the war. If the British people cannot afford to buy their own goods, how can they expect foreigners to do so?

It would be both inaccurate and unfair to convey the impression that the Labor Government is insensible to the need for improving efficiency and reducing costs. The Government is promoting an ambitious (possibly too ambitious) program of investment in industrial reequipment and modernization for that very purpose. Sir Stafford Cripps has used all the prestige and authority of his office to gain the cooperation of labor in holding the line on wage increases. Despite some exceptions and an increasing restiveness among the rank and file of labor, the average level of wages has been held remarkably steady over the past year. The leadership of Britain's Trade Union Congress, in a frank report to be submitted to the annual convention this month, bluntly tells the nation's 8,000,000 organized workers that business is being taxed to the limit, and that their only hope for an improved standard of living is to work harder.

Cutting Costs a Painful Process

But, as The Economist says, cutting costs is a painful operation; it will not be undertaken "simply because Ministers make radio speeches saying the national interest requires it; it will be undertaken only when the individual manager or the individual worker finds himself under individual pressure to cut costs for which he is responsible as the only means of avoiding something he dislikes even more."

One of the factors involved is the overall fiscal and credit policy of the Government. The London Statist of June 4, in an article entitled "U.S. Deflating While Britain Inflates?", cites authority for the view that present British budget and credit policies are promoting inflation and that planned investment expenditures exceed savings; and it warns of adverse consequences upon the balance of payments.

The Economist, in the July 9 issue, calls on the Government to show the way to a general reduction of costs "by cutting the biggest item of national costs, the burden of taxation, since it is absurd to hold that a Budget of £3,300 million cannot be slashed if there is a will to do it." The Economist then proceeds to enumerate other key points in a hypothetical policy that a government "that put the reduction of costs of production above anything else" would adopt: —

> Wherever it possibly could — outside a narrow range of strict necessaries — it would remove controls and allocation quotas and allow prices to be determined competitively . . .
>
> In every possible way, it would make businessmen once again work for their livings.
>
> It would abandon the cheap money fetish and let interest rates find their level.
>
> It would bring in legislation against all form of restrictive practice. It would insist on payment by results in every industry where a scheme could possibly be introduced.
>
> And if there were no other way of persuading the unions and their members to give value for money, it would welcome the therapeutic effect of a moderate degree of unemployment.

Dilemma of the Labor Government

Most of this, however, is anathema to British socialism which, while it wants to reduce costs, will accept no interference with the development of the "welfare state". In apparent reply to suggestions that to meet the economic crisis Britain should be prepared to accept some moderate amount of unemployment, and to cut back government spending, including presumably some reduction in the costly social services, Prime Minister Attlee in a speech July 3 asserted, "We are not prepared to tolerate the misery and loss of human happiness which the old system entailed." As Sir Stafford Cripps declared in his July 6 statement to the House of Commons, "The Government and the nation are pledged to a policy of maintaining full employment and protecting our present standard of living."

This, then, is the dilemma of the Labor Government and of the British people. Though the situation is critical and calls for the united effort of the nation to save, to increase production, and to cut down costs, yet the great mass of the British people are to continue to be protected from feeling individually, in any comparable degree, the pressures that bear upon the community as a whole. Enterprise and incentive, apparently, must go on contending against a tax load that takes 40 per cent of the national income.

Problem Primarily British

This problem of costs and competitive ability is of course one that will have to be resolved by the British people in their own way. They will rightfully resent gratuitous advice from outsiders on how to conduct their affairs, and still more any attempt to exert pressure toward particular policies.

At the same time, it must be recognized that the confidence of the American people in present policies has been seriously shaken. After having poured out since the end of the war something like \$23 billion in foreign recovery grants and loans (much of the latter unlikely to be repaid), with federal budget expenditures for foreign aid and reconstruction running currently at a rate exceeding \$6½ billion annually, and with the huge commitments under the Marshall Plan still

unfulfilled, the American taxpayer, facing a budget deficit at home, is reaching the limit of his desire to make further foreign grants and loans without assurance of greater results.

Canada, which has rendered generous financial aid to Great Britain since the war, evidently shares this feeling. The Canadian Finance Minister, Mr. Abbott, said this Summer:

> The problems of the sterling area are internal problems, and temporary expedients such as loans are not the real answer to the problem. I think as far as Canada is concerned we have gone about as far as we can in the way of loans.
>
> The essence of the British problem is to get costs of production down and to raise productivity. The eventual solution must come from the action of the British Government itself.

As was pointed out at the outset of this article, there was agreement in London this Summer that remedies should be sought "other than financial assistance such as that provided by the United States and Canada." Subsidies disguised as "investments", government purchases of commodities at artificially high prices, etc., are likely to be equally unpalatable. There is neither justification for, nor likelihood that the American people would favor, deliberate debasement of the dollar by raising the official buying price of the U. S. Treasury for gold. Within the past few days Secretary of the Treasury Snyder has said explicitly that no revaluation of gold or similar expedient to cheapen the dollar will be resorted to in connection with the British problem.

Summary and Conclusion

Thus, in conclusion, we say again that the problem comes back largely to the British themselves. Broadly speaking it involves two things —

(1) Rectifying the dollar deficit on current account by either selling more British and sterling area goods and services to "hard currency" countries, or importing less from such countries. and

(2) Controlling capital outflow, now represented both by leakages in the controls, and by releases of old sterling balances and building up of new investments abroad.

One suggested method of dealing with these problems is a devaluation of the pound, which would have the effect of an across-the-board price cut on British and sterling area goods in foreign markets, and might also, temporarily at least, check pressures upon sterling resulting from selling by holders who fear its depreciation.

To this method, however, the British authorities have been, understandably, strongly opposed. For one thing, cheapening the pound would increase the sterling cost of imports from non-sterling countries (unless they too devalued), thus tending to set in motion an offsetting wage-price spiral at home. Secondly, no one knows whether cheapening the pound would promote enough increase in the volume of exports to hard currency countries to make up for the decrease in their price. Upon one point there is universal agreement — that devaluation provides no lasting solution unless accompanied by other measures to cut costs, increase efficiency, and expand the production of goods and services that can be offered abroad at prices in line with those of competitors.

As regards transfers involved in repayment of sterling liabilities or increase in new foreign investment, the question is being raised in Britain as to whether she is not attempting too much in this direction when the need for devoting all available resources to meeting the dollar deficit is so urgent.

President Truman in his Philadelphia address August 29 promised to the distinguished Britishers and Canadians who will visit Washington this month a warm welcome and an examination of mutual problems "in a spirit of friendliness and helpfulness". He laid down the principle that efforts to expand the exchange of goods should be persisted in, and he did much to allay misunderstanding by stating that "democratic nations are not proposing to interfere in one another's internal politics." With all the difficult economic and technical considerations, it is to be hoped and may be fairly assumed that the conferees, and the peoples they represent, will always have in their mind the consciousness of the essential unity of the three countries in the struggle they have gone through together, and their joint responsibilities for maintaining a peaceful democratic world.

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